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THE INSTITUTION OF A STOCKMARKET IN A SOCIALIST ECONOMY: NOTES ON THE CHINESE ECONOMIC REFORM PROGRAM

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ABSTRACT

This paper is concerned with three questions: (a) how would a stockmarket help economic and industrial development in a country like China; (b) will a stockmarket be system-compatible; and (c) if a full-fledged stockmarket is indeed introduced in a socialist economy, can its "negative influences" (speculation, booms and crashes) be minimized? These issues are examined analytically with the help of empirical evidence of stockmarket behavior in advanced and newly industrializing economies. Although the paper considers the specific case of China, the argument is more general and has application to other developing as well as centrally planned economies.

RESUMEN

Este artículo plantea tres preguntas: (a) cómo podría contribuir un mercado de valores al desarrollo económico e industrial de un país como China; (b) sería compatible con el sistema un mercado de valores; y (c) si se introduce un mercado de valores completamente desarrollado en una economía socialista, ¿pueden reducirse sus "influencias negativas" (especulación, auges y crisis)? Se examina estas cuestiones de manera analítica con base en la evidencia empírica sobre el comportamiento del mercado de valores en las economías avanzadas y las de industrialización reciente. Aunque este artículo analiza el caso específico de China, el argumento es de carácter más general y podría aplicarse a otras clases de economías en desarrollo tanto si como a aquellas con planificación centralizada.

I. INTRODUCTION

The General Secretary of the Chinese Communist Party, Zhao Zi Yang, in his report to the Party's Thirteenth National Congress observed as follows in relation to "restructuring" the Chinese economy:

> The reform we have already carried out includes the development of different types of ownership, public ownership remaining predominant, and even allows the private sector to exist and develop. This reform is determined by the actual condition of the productive forces in the primary state of socialism, and it is the only way to promote their development. Some of the things we have introduced in the process of reform, such as expanded markets for means of production, funds, technology, and labour service, and the issuance of stocks and bonds, are phenomena which are not peculiar to capitalism but are bound to appear in the wake of large-scale, socialized production and the development of the commodity economy. Socialism can and should make use of them, trying at the same time to minimize their negative effects in practice.[1]

The main purpose of this paper is to consider the usefulness of the institution of the stockmarket in the present circumstances of the Chinese economy. Specifically, the following questions are raised by such an investigation:

1. How if at all will a stockmarket help the "development of productive forces," i.e., economic and industrial development in China?
2. Will a stockmarket be system-compatible, i.e. conform to socialist values, even those of "socialism with Chinese characteristics"?[2]
3. If a full-fledged stockmarket is indeed introduced, can its evident "negative influences" (speculation, stockmarket booms and crashes) be minimized?

In recent years, China has established embryonic stockmarkets in Shanghai, Beijing, and other large cities, with limited trading in company shares. Professor Li Yining of Beijing University, a leading exponent of economic reform in China, told the *New York Times* last December that "By 1995 virtually every state-owned corporation will have issued shares that will be publicly traded on exchanges around the country." Mr. Li believes that the government should retain control of at least 25% of most companies but that the remaining 75% or less of the shares should be freely traded. He is reported as saying "There is no turning back. We have no other way to go." More significantly, in the same despatch, General Secretary Zhao Zi Yang, is quoted as telling an audience, "The shareholding system will be carried out step by step."[3]

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[1] Zhao 1988.
[2] The title of General Secretary's Zhao's report is "Advance along the Road of Socialism with Chinese Characteristics."
[3] *New York Times*, 5 December, 1988.

Although there is evidence of a slowdown in the pace of reform this year in the face of China's economic difficulties, the questions outlined above will continue to be important. Moreover, the significance of these issues extends beyond China since many other socialist countries are also presently experimenting with share ownership and stockmarket institutions, e.g. Hungary and Yugoslavia.[4]

II. THE FUNCTIONS OF A STOCKMARKET IN A CAPITALIST ECONOMY

A natural starting point for a discussion of the desirability of establishing a stockmarket in a socialist economy is to ask what functions does the stockmarket perform in a capitalist society where such markets have long been in existence. Following Hughes and Singh (1987) we note that, in theory, the stock exchange has a triple role: first, to pool together society's savings dispersed among individual savers; second, to selectively channel these savings to companies with the best investment prospects; and third, to encourage the efficient use of assets embodying past savings. Two interrelated mechanisms are involved: a primary market mechanism whereby new issues of shares are made by companies wishing to raise funds; and a secondary market mechanism whereby trade in existing shares of companies is carried out. A company whose equities are traded at a relatively low price will find it more expensive or even impossible to raise new funds in the primary market. It may also be subject to the threat of a takeover in which a majority stake in its equity is acquired by another company whose objective is to change policies to improve the stock price. Management teams may thus complete in a market for corporate control, and takeovers on the stockmarket may then be interpreted as an essential part of the competitive selection process in a capitalist economy.

A central question is how well, in fact, are these supposed functions actually performed by the real-world stockmarkets? There is a voluminous literature on these issues but for the purpose of the analysis of this paper the essential points may be summarized as follows. As far as the savings function is concerned, the stockmarket, it turns out, makes at best a very limited contribution to social savings. For a number of reasons, managers in large corporations avoid going to the stockmarket to raise funds by means of issues of stocks and shares (Baumol 1968; Singh 1971; Stiglitz 1985). In a recent paper, Mayer (1988) used flow of funds accounts to show that between 1970 and 1985, in the two leading stockmarket economies, the UK and the US, new issues made a *negative* contribution (i.e., there were net receptions of shares due to takeovers) to net investment in the nonfinancial corporate sector. In these two countries the nonfinancial corporations financed most of their net investment from retentions (in the case of the UK, more than 100%).

[4] For Yugoslavia see, for example, Uvalic 1988; for Hungary see, for example, Nuti 1988.

The investment in large corporations in capitalist countries is thus carried out overwhelmingly through retained profits or through borrowings from banks. Moreover, there is evidence that the retained earnings are not as profitably utilized as they might be: the rate of return on ploughed-back profits tends to be considerably less than on new issues or debt (Baumol, Heim, Malkiel, and Quandt 1971; Whittington 1972).

Crucial to the allocative and the disciplinary function of the stockmarket is the efficiency of the pricing process. Only if the trading activity on the stockmarket is such as to yield relative share prices of firms that more or less correspond to their relative expected profitability will the market be at all able to effectively carry out these tasks—rewarding the profitable enterprises by making funds to expand available to them cheaply and punishing the unprofitable companies by making them decline or disappear.[5]

There are many studies purporting to show that stockmarket prices are "efficient" in the sense, for instance, of rapidly incorporating new information (Keane 1983). There is not much, however, to suggest that share price movements are systematically related to the current, past, or subsequent underlying performance variables of companies, or to longer run equilibrium considerations rather than those of short-run equilibrium (Nerlove 1968; Little and Rayner 1966; Shiller 1979; Summers 1986). It is the influence of "short termism"[6] and of speculators on the stockmarket that led Keynes to observe in the *General Theory*: "Speculators may do no harm as bubbles on a steady stream of enterprises. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of laissez-faire capitalism..."

Although "efficient" prices in the sense outlined above are a necessary condition for the stockmarket to perform its essential tasks, they are not sufficient. Sufficiency requires, in addition, that the "takeover mechanism" be efficient so that all those companies whose profitability under their existing managements was lower than it could be under any other management were acquired by the latter. For large management controlled oligopolistic corporations in capitalist economies, for which the natural selection process on the product markets may not work, the takeover mechanism is the only effective market-based disciplinary

[5] In the normal calculus of a capitalist economy, private profitability is taken to be an indicator of "efficiency." There are well-known reasons why private and social valuations and private and social costs may differ even in a perfectly competitive equilibrium market economy.

[6] The term refers to the short-term time horizon of many important players on the stockmarket—for example fund managers of financial institutions whose own performance as managers is judged by short-term results. See Cosh, Hughes, Lee, and Singh 1989.

device.[7] However, modern theorists of the firm and economic organization have argued in recent contributions that for a number of powerful reasons even in *principle* the takeover device may not work effectively even when the prices are "*efficient*."[8]

More significantly, empirical studies of the actual nature of the takeover selection process on the stockmarket show that in general it is not the case that only the unprofitable companies are taken over, nor that the greater the profitability of the stockmarket valuation of a company, the correspondingly lower its chances of acquisition. Evidence from a wide range of studies for the UK, the US, and other industrial countries indicates that the takeover selection takes place only to a very limited degree on the basis of profitability; it does so much more in terms of the size of the company. A large, relatively unprofitable company has a much greater chance of being immune from takeover than a much more profitable but small company. In fact, in the real-world stockmarkets, making an acquisition to increase size might itself become a tactic to avoid takeover (Greer 1986; Singh 1971).

If we turn from the question of what kinds of companies are taken over on the stockmarket and by whom to that of what happens to resource use following takeover, the empirical evidence is no more reassuring. In addition to their disciplinary role, takeovers also provide an important mechanism in a capitalist economy for the reorganization of the capital resources of the society in response to changing technology tastes and market conditions. However a wide range of empirical studies comparing pre- and post-merger profitability indicate that on average the profitability of merging firms does not improve after merger. To the extent that the monopoly power of the acquiring company in the product market may increase as a consequence of takeover, this evidence is compatible with reduced efficiency in resource utilization following mergers.[9]

Finally, in relation to the actual behavior of stockmarkets and their impact on economic development in the capitalist countries, it is useful to note that until recently the stockmarket has played a major role only in the US and the UK economies. It has historically been much less important in countries like West Germany, France, Japan, or Italy. In these non-Anglo-Saxon industrial economies, until the 1980s a comparatively small number of companies was listed on the stockmarkets. Trading was relatively thin as the share ownership was not as widely dispersed as in the US and the UK. In West Germany, for example, the banks have played a much bigger role in savings, in the allocation of capital, and in the disciplining of firms than the stockmarket (Cable 1985). It is significant that the overall economic performance of the stockmarket dominant

[7] See further Singh 1971, 1975; Meade 1968; Alchian and Kessel 1962; Manne 1965. Because of the so-called principle/agent problems in the large management controlled corporations, shareholders dispersed throughout society may not be able to get the managers to act in the shareholders' interests rather than in the managers' own self-interest.
[8] See for example Grossman and Hart 1980; Stiglitz 1985.
[9] For systematic evidence on this subject for a number of industrial countries, see Mueller 1980.

economies of the US and the UK over the last 40 years has been much poorer than that of the non-stockmarket economies. It is indeed true that during the 1980s the financial markets were being liberalized in most advanced countries, including the non-Anglo-Saxon ones. However, the impetus for such liberalization in countries like Japan and West Germany comes more from the current imbalances in the world economy and from US political pressure than from the exigencies of economic development.[10] There is reason to believe that the "forces of production" in the hitherto non-stockmarket economies are more likely to be harmed than helped by the globalization and liberalization of financial markets that is presently taking place.[11]

III. STOCKMARKETS AND SHARE OWNERSHIP IN SOCIALIST ECONOMIES

In the textbook theories of socialist economics, the allocation of investment has usually been regarded as one area where socialism has a clear advantage over market economies. There are several reasons for this view which are well known in the literature.[12] Briefly, first, as Scitovsky (1954) pointed out a long time ago, in the absence of complete futures markets, market prices in a capitalist economy do not provide necessary information for the ex ante coordination of investment plans of firms. This serious deficiency of market economics can then only be remedied by the government planning of investment resources. Secondly, the planners can in principle allocate social capital on the basis of social needs rather than private profitability which may not always coincide with such needs. Thirdly, the government can ensure full utilization of resources which the market economy, left to itself, may not necessarily be able to achieve—the usual Keynesian argument. In view of these considerations, even in the Lange-Lerner economy of market socialism and decentralized profit maximization by the managers of individual firms, the control of investment decisions was envisaged to be vested in a government planning agency.

However, as opposed to this idealized picture, the actual experience of "realized socialism" has been rather different.[13] Total investment has often turned out to be "excessive," contributing to Kornai's "shortage economy" syndrome in socialist countries. There are well-known investment cycles, and at the microeconomic level there are myriad examples of inefficient utilization immobility and misallocation of resources. For these and other reasons several planned economies in Eastern Europe as well as China have embarked on an economic reform programme, which essentially involves marketization and managerial autonomy. The process of reform has normally been piecemeal and protracted, leading at each step to difficulties whose resolution in the eyes of the reformers requires further reform.

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[10] For a fuller analysis of this issue, see Cosh, Hughes, and Singh 1989.
[11] Ibid.
[12] For one of the earlier analyses of these issues, see Dobb 1939.
[13] See, for example, Kornai 1980; Bauer 1978; Nuti 1988a.

Thus in China, following the death of Mao, first the agricultural sector was liberalized by the abandonment of people's communes. Next, the reformers turned to the urban economy and over time a large number of commodities has been taken out of the hands of the central planners for their prices to be determined "freely" by market forces (Naughton 1986). At the same time, several steps were taken to provide greater managerial and enterprise autonomy. In 1984, the government published a list of ten principles which were intended to greatly increase the ability of managers in state-owned enterprises[14] to make their own production, marketing, and pricing decisions (Griffin 1986). Managers were also given *more* discretion to determine the internal organization of the firm, to choose their management teams, to recruit workers. The state enterprises were also permitted to dispose of or rent unneeded fixed capital assets (provided the capitalized value of the enterprise remained the same) and to retain 70% of the depreciation funds.

Following the classic dynamic of reform, these changes in turn have lead to calls for a review of the question of ownership and that of property rights. Two important arguments are made in this respect. First it is suggested that the present position where in principle a state enterprise is "owned by the whole people" is too abstract and does not provide the proper incentives for managers and workers to make best use of the enterprise's resources. Secondly, it is argued that "managerial autonomy" can only be properly ensured by a change in property rights—by selling shares in state-owned enterprises to specific institutions (e.g. banks, provincial or local governments) or private individuals. Thus Gu and Liu (1988) observe: "the noteworthy problem is that when the property rights remain ambiguous, the redistribution of benefits is not able to make the enterprise have long-term aims and truly form a self-restricting and self-promoting managerial mechanism. Therefore the reform aimed at radically improving the enterprise's managerial mechanism should start with the rationalization of the relations between property rights and determination of property ownership. This requires that the profits obtained by the enterprise, after delivery to the state of the returns on state assets and taxes, should belong to the enterprise and so should the reinvested amount of the retained profits and return from them. The enterprise, according to law, has the right to own, use, collect income from, and dispose this part of assets." They go on to claim: "we can thus see that the introduction of the system of shares into state-owned enterprises is not simply a subjective choice, but represents an objective demand by China's economic life after the reform and constitutes the basic chain of change in the enterprise mode."

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[14] There are over 60,000 state enterprises in China which account for about 75% of aggregate industrial output. Out of the total non-farm work force of 133.4 million in 1988, state-owned enterprises employed 97.9 million workers, collectives 34.9 million, and private enterprises 0.8 million. See the *Economist*, 21 January 1989.

Once shares have been issued, the next step in the line of reasoning of the reformers is to suggest that there should be a market for these shares. This is thought to have two significant advantages. 1) It would make it possible to weed out inefficient management teams by market rather than political processes. 2) The "missing" capital market will help in the efficient allocation of resources without government interference.[15]

Turning from theoretical considerations to actual practice, the *New York Times* estimates that currently 7,000 to 10,000 Chinese companies have issued shares. There are stockmarkets in Shanghai, Beijing, and Shenyang and a few other provincial cities. The biggest market appears to be Shanghai where more than 350,000 people own shares issued by over 1,000 companies. However, the shares issued are more in the nature of bonds than equities since they carry a fixed interest and do not provide clear ownership rights. Many of the shares are held by enterprise employees and various government agencies. Trading tends to be rather limited as few people sell shares once they have purchased them. However, it is reported that a group of financial institutions is attempting to establish a national stock exchange modelled in part on the exchanges in New York, Milan, and Tokyo.

For Hungary, Nuti (1988a) reports that there has been a bond market in operation since 1983. There are both primary issues of bonds and secondary trading for enterprises (nonstate guaranteed) as well as households (guaranteed). Bond issues have increased overall thirtyfold over a five-year period and purchases by households have increased a hundredfold. It appears to be the case that ordinary shares have also been issued by some state enterprises and are retraded but until now exclusively among the enterprises themselves.

In Algeria, which until recently was run as a traditional centrally planned economy, economic reform has taken a different approach to share ownership and enterprise management. Following the government decree of January 1988, the state-owned enterprises were turned into joint stock companies with shares owned by the state. Eight independent holding companies (not entirely specialized by sectors), the so-called *fonds de participation*, were set up to manage these state enterprises. Fund managers, whose performance is supposed to be judged by the financial results of their portfolios, can alter their holdings by trading with each other. The purpose of the system is apparently to simulate the disciplinary and allocative functions of a stockmarket.[16]

To sum up, the above account suggests that although share ownership and stockmarkets in China and other socialist countries are at present at a rudimentary stage, their future role in these economies in the eyes of many of the reformers is potentially very important.

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[15] A number of different proposals concerning share ownership and trading in shares have been made by Chinese reformers. A notable recent contribution is that of Hua Sheng, Zhang Xuejun, and Luo Xiaopleng. Their views, first outlined in *Economic Research*, were given an airing in the *People's Daily* in January 1989.

[16] See Nuti 1988a.

IV. THE STOCKMARKET AND ECONOMIC DEVELOPMENT IN CHINA

In what ways and through what channels will the institution of stockmarkets promote the "forces of production" in the Chinese economy? The first crucial point to note here is that by conventional macroeconomic criteria China has an exceptionally successful industrial economy. As Table 1 indicates, the Chinese industrial growth rate during the period 1965-80 was quite respectable by international standards, even though the first ten years of this period involved all the upheavals of the Cultural Revolution which particularly affected industry. China's industrial economy expanded at a faster rate during these fifteen years than that of most developing countries including the highly successful Latin American giants, Brazil and Mexico.

In the 1980s China's industrial record has been spectacular: industry has developed at a quicker rate in that country than almost anywhere else in the world. Whereas the tempo of industrialization in the Latin American countries such as Brazil and Mexico has succumbed to the debt crisis and the slowdown in world economic growth during this decade, the Asian semi-industrial countries have continued to expand.[17] However, Chinese industrial growth in the 1980s has been even faster than that of South Korea. Table 2 indicates that China's overall economic performance in the 1980s—at least in terms of GDP growth—has also been extremely good. (It was just creditable but not outstanding in the earlier period, mainly because of the relatively much slower growth in agriculture.)

Nevertheless there are at present serious macroeconomic imbalances in the Chinese economy and it is believed by the reformers that the development of the stockmarket will help to correct such disequilibria. The most important of these is reflected in the high rate of inflation that China is currently experiencing. Further, the rate of investment is thought to be too high and its sectoral allocation is regarded as inappropriate. In addition, the reformers point to a wide range of microeconomic inefficiencies in the economy. We consider below the implications of the establishment of a stockmarket for each of these areas.

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[17] For an analysis of the differential performances of Asian and Latin American industrial economies in the 1980s, see Singh 1989.

TABLE 1

Growth of Industrial Production and Share of Industry in GDP Semi-Industrialized Countries: 1965-80, 1980-86

	Growth of Industrial Production (% per annum)		Structures of Production Share of Industry in GDP	
	1965-80	**1980-86**	**1965**	**1985**
China	10.0	12.5	38	46
India	4.0	7.1	22	29
Mexico	7.6	-0.1	31	39
Brazil	9.9	1.6	33	39
South Korea	16.5	10.2	25	42
Developing Countries	7.2	4.6	31	36
Middle-Income Developing Countries	7.2	2.1	33	36
Low-Income Developing Countries	8.4	1.2	25	30
Industrial Countries	3.2	2.5	40	35

Source: *World Development Report* 1988.

TABLE 2

Growth of GDP in Semi-Industrialized Countries: 1965-80, 1980-86

	1965-80	**1980-86**
China	6.4	10.6
India	3.7	4.9
Mexico	6.5	0.4
Brazil	9.0	2.7
South Korea	9.5	8.2
Developing Countries	6.1	3.8
Middle-Income Developing Countries	6.6	2.3
Low-Income Developing Countries	6.5	1.8
Industrial Countries	3.6	2.5

Source: *World Development Report* 1988.

1. Inflation, Savings, Investment, and the Stockmarket

Table 3 indicates that China has long been a low-inflation country. Until 1980, there was hardly any recorded inflation at all. However, with the progressive decentralization of the economy, inflation began to accelerate in the 1980s and had reached, by Chinese standards, very high levels by 1988. The official rate of inflation was 7.8% in 1987 and 20.7% in 1988.[18] In the early months of 1989, inflation was reported as running at an annual rate of over 30%[19]—clearly a cause for immense concern for the Chinese people and the leadership.

TABLE 3

Rates of Inflation in Asia and Latin America, 1963-1984
(average annual rates of growth of consumer price index, in percentages)

Asia	**1963-73**	**1973-79**	**1979-84**
China	-0.5[a]	0.6[b]	3.0
India	8.3	6.3	10.0
Indonesia	42.1[c]	19.7	12.5
Korea	13.2	17.9	12.1
Malaysia	2.1	6.2	6.0
Pakistan	5.1	14.8	9.2
Philippines	7.9	13.3	19.8
Sri Lanka	4.3	7.3	17.0
Taiwan	3.5	12.0	12.9[d]
Thailand	3.2	9.7	8.3
Median	**4.7**	**12.0**	**10.0**
Latin America			
Argentina	n.a.	181.5	222.8
Bolivia	8.2	17.4	195.6
Brazil	31.4	38.6	121.6
Chile	n.a.	167.9	22.1
Colombia	11.2	23.7	22.8
Ecuador	5.9	14.5	23.6
Mexico	4.5	19.8	53.7
Peru	9.9	38.2	82.8
Venezuela	2.2	8.9	13.0
Median	**8.2**	**23.7**	**53.7**

n.a. = not available

[a] 1965-70. [c] 1966-73.
[b] 1970-79. [d] 1979-82.
Source: *World Bank Data Bank.*

[18] *IMF Survey*, May 1, 1989.
[19] *Economist*, 25 February 1989.

It is argued by the reformers that the creation of a proper stockmarket will help reduce inflation by promoting savings. This argument, however, is not convincing for at least three reasons. Firstly, as Table 4 suggests, China already has one of the highest rates of domestic savings in the world. At 36% of GDP in 1986, it was considerably higher than that of the various groups of developing countries as well as of the Third World as a whole. It was also greater than that of South Korea. Nevertheless, to the extent that it is suggested that domestic savings in China should increase still further, higher real interest rates on bank deposits and/or, better still, extension of modern banking to rural China are likely to be better ways of achieving this objective than the attractions of an equities market which may be subject to considerable volatility.[20] The banking system or the financial institutions could also introduce some additional more flexible instruments of savings deposits as indeed some banks have already been doing in recent years.

TABLE 4

Gross Domestic Investment and Gross Domestic Savings as Percentage of GDP: Semi-Industrial Countries, 1965 and 1986

	Investment		**Domestic Savings**	
	1965 (%)	**1986 (%)**	**1965 (%)**	**1986 (%)**
China	25	39	25	36
India	18	23	16	21
Brazil	20	21	22	24
Mexico	22	21	21	27
South Korea	15	29	8	35
Developing Countries	15	29	20	24
Middle-Income Developing Countries	21	23	21	24
Low-Income Developing Countries	17	19	16	17
Industrial Countries	23	21	23	21

Source: *World Development Report* 1988.

Thirdly, the important point is that inflation is a macroeconomic phenomenon, caused by too high a level of aggregate demand. This is in part due to a very high level of investment. (Gross domestic investment as a proportion of GDP was 10 percentage points greater in China in

[20] On the question of volatility, see below. To the extent that it is argued that Chinese households are not rise averse but prefer risk the state can indulge such tastes by running lotteries, as indeed many socialist countries already do. A straightforward state-run lottery is better than gambling on the equities market with real enterprises.

1986 than in South Korea—see Table 4). This in turn arises from the growing loss of central control over investment decisions of enterprises since the beginning of the economic reform (Naughton 1986). Other significant causes of inflation include decentralized bonus payments to employees by individual enterprises and the consequent breakdown of what effectively until the late 1970s had been a strict incomes policy (Singh 1979; Griffin 1986). At a deeper level, the inflationary problems arise from the fact that although the overall rate of Chinese economic growth has been very high, there is no longer any social consensus on the distribution of income, thus leading to conflicting claims over the national product. However, the essential point is that the reasons and remedies for inflation lie in the macroeconomic sphere and the institution of the stockmarket is unlikely to help in this respect; on the contrary, it could make matters worse. The Chinese government has been reluctant to use macroeconomic stabilization measures because of the fear of causing "stagflation" in the economy. Without such macroeconomic stabilization, a likely stockmarket boom under inflationary conditions would make control over prices more rather than less difficult.

2. Sectoral Allocation of Investment

The question of the overall level of investment has been discussed above. As far as the allocation of investment is concerned, there are two broad issues: (i) the allocation of investment among the broad sectors of the economy; (ii) its allocation among enterprises within a sector or industry. We shall briefly consider (i) here; (ii) will be examined in IV.3 below.

At the end of the 1970s, the Chinese government identified many important structural imbalances in the economy, e.g. a too high and ever increasing share of industry in the GDP and too low a share of services; the sluggish growth of agriculture; within industry, an excessive share of heavy industry in the industrial product (World Bank 1985). Since 1980, many of these imbalances have been greatly reduced to the clear benefit of the standard of living of the Chinese people. There has been a huge improvement in both the quantity and the quality of available consumer goods. A number of new products, e.g. color televisions and VCRs, have been introduced. Urban housing has vastly improved. However, as Riskin (1988) rightly points out, many of these changes have been brought about by the macroeconomic actions of the central planners (rather than through "reform" as normally understood), for example, through allocating greater investment resources to the consumer goods industry, to housing, etc. In Chinese institutions' circumstances, it is difficult to see that a stockmarket would have been able to bring about such enormous changes in the *broad* sectoral investment allocation more quickly or more effectively than the country's central planning mechanism.

3. Microeconomic Efficiency and Intrasectoral Investment Allocation

At a microeconomic level, Chinese industrial enterprises are thought by the reformers to have a number of serious weaknesses:

(a) As a consequence of the soft budget constraint in the socialist countries, there exists a considerable degree of x-inefficiency in Chinese firms.

(b) Managers in state-owned enterprises—"owned by the whole people"—do not have appropriate performance incentives. This contributes significantly to x-inefficiency.

(c) There is inefficient allocation of intraindustry investment resources since there is underutilization of capacity in some enterprises whilst there is overutilization in others. Resources do not flow from enterprises that are using them less efficiently to those that are, or could, utilize them more effectively.

(d) There is no clear-cut arm's length mechanism for changing inefficient management teams. At best this is done through political processes rather than on the objective basis of the quality of enterprise management.

A central question is whether share ownership and the institution of the stockmarket are the only or the best way of solving these problems. With respect to these issues, several observations are in order. Consider (a) the question of x-inefficiency. First, as noted earlier, notwithstanding all the essentially a priori concerns as well as casual evidence about x-inefficiency in Chinese industrial enterprises, it must be stressed that China's overall industrial growth rate has been extremely high, among the highest in the world. Secondly, to the extent it is argued—quite correctly—that if x-inefficiency were reduced overall industrial growth would be higher still, this goal is likely to be better achieved through competition in the product markets rather than through the disciplinary mechanisms of the capital market. As seen in Section II, even in advanced capitalist economies with highly organized capital markets, the stockmarket is a poor disciplinarian of large management controlled corporations.

Turning to (b), the question of managerial incentives in state-owned Chinese enterprises, it is important to reflect that share ownership and the stockmarket are by no means the only ways of inducing optimal managerial performance. The growing literature on "privatization" of state-owned enterprises in the advanced as well as the developing countries is relevant here. Kay and Matthew (1988) have noted on the basis of their comparison of state-owned and privatized enterprises in the UK that "privatization" is neither a necessary nor a sufficient condition for improving enterprise performance. Rather, they suggest that the promotion of product market competition is a greater spur to microeconomic efficiency than the transfer of ownership. Similarly, the experience of POSCO, the giant Korean state-owned steel company, is instructive. POSCO is by far the most successful steel producer in the world, even more successful than the

Japanese steel companies. Aylen (1987) notes that its success is due to its being set clear-cut goals, given managerial autonomy, and being subject to market competition. Managerial autonomy is clearly not ruled out by state ownership.

It is also important to bear in mind that profit sharing can be, and indeed, is used as an incentive for workers and managers in state-owned enterprises in many countries, including China, without either share ownership or a stockmarket. Moreover, if it is felt that employees would have an even greater incentive to perform better if they had in addition an ownership stake in the enterprise, they could be issued shares without there being a stockmarket in these shares. In fact, this particular incentive can work best only if the workers are obliged to retain their stake in the firm and not to sell it.

Let us now examine (c), the issue of interfirm allocation and mobility of capital. Would it be *best* facilitated by the stockmarket or by other mechanisms? The first important point to note in this connection is the normal volatility of stockmarket prices. In the wake of the stockmarket crash of October 1987 in New York, London, and elsewhere, there has been an important debate on the question whether, as a consequence of liberalization of the world stockmarkets and introduction of new devices such as programme trading in recent years, the markets have become more volatile than before. Although the evidence from the Brady Commission (appointed in the US to investigate the 1987 crash) and other sources suggests that the volatility has not *increased* compared, say, with the 1930s,[21] the fact remains that the share prices on the stockmarkets are normally highly volatile. It is useful to reflect here on the recent behavior of some Third World stockmarkets. Between 1982 and 1985 share prices on the Brazilian stockmarket rose fivefold in US dollars terms; two years later they had dwindled to 28% of their 1985 value. In 1988 the market had risen again by 40%. In Taiwan the stockmarket more than quadrupled from the beginning of 1987 to mid-1988 before crashing; it is still slightly less than 40% of its 1988 all-time high.[22]

In the light of such volatility of share prices, interfirm allocation of investment resources through the stockmarket would not appear to be a very sensible course. Indeed in a different but related context, Williamson (1970) regarded such volatility and other imperfections of the stockmarket as an important reason why a so-called M-Form corporate organization will perform better than a U-Form organization. The “central office” of the M-Form organization, acting as a “surrogate” capital market, can provide a superior mechanism for allocating investment resources to the different subsidiaries relative to the real-world stockmarkets. The practical implication of this view for China’s industrial management is that instead of establishing actual stockmarkets, they should attempt to create surrogate markets for intraindustry resource allocation. One method of

[21] See Cosh, Hughes, and Singh 1989.
[22] See the *Economist*, April 29, 1989.

doing this would be to establish state-owned holding companies and entrust them with the overall management of groups of industrial enterprises—much like an M-Form organization. These holding companies should be allowed to compete with each other and their managerial performance should be judged by their financial results.

With respect to (d), the related question of the change of inefficient managements through the market rather than political processes, the experience of the stockmarket economies of the US and the UK with the takeover mechanism is far from being a happy one. For many of the reasons discussed in Section II, an increasing number of scholars regard involuntary takeovers as a costly, inefficient, and cumbersome mechanism for forcing a change in corporate management. There are often huge transactions costs (particularly if the takeover bid is defended) and enormous speculation in shares, and at the end of the day it is far from clear whether the management that actually succeeds in a takeover battle is in fact better at long-term industrial management rather than being simply more adept at short-term financial manipulation. These considerations have led to calls, both in the US and the UK, for separating the market for shares from that of corporate control.[23] It is suggested that it would be better for management changes to occur through active participation by financial institutions (who now hold the bulk of corporate shares in the Anglo-Saxon countries) in corporate affairs than by the takeover process. It is interesting to note in this regard that in countries like Japan there are hardly any “involuntary” takeovers on the stockmarket. In the light of the experience of the advanced countries, it would not seem sensible for a developing country like China to adopt such a costly and uncertain system of enforcing management changes in industrial enterprises.

V. CONCLUSION

The foregoing analysis suggests that as far as the promotion of “forces of production” is concerned, the institution of the stockmarket in the present circumstances of China’s economy is unlikely to make a positive contribution. In the inflationary conditions that have prevailed in the country in recent years, a stockmarket could in fact have a negative influence on economic and industrial development by contributing to overall instability. This paper suggests that the “negative features” of the capitalist institutions which General Secretary Zhao referred to in his speech at the 13th Congress (see Section I) are best overcome in the case of the stockmarket by not having an actual stockmarket but rather by simulating its functions via the establishment of new financial institutions. These would in effect be competing holding companies of industrial enterprises. The holding companies would have managerial autonomy and their performance

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[23] See a recent Bank of England discussion paper, Charkham 1989. In the US, a number of individual states have adopted laws to restrict involuntary takeovers.

would be judged by financial results. Further, it is argued here that at the present stage of China's development, to increase microeconomic efficiency, the reformers should pay greater attention to the promotion of competition in the product markets.

The question of the system-compatibility of the stockmarket with socialism has not been given specific attention in the above discussion. This is mainly because “socialism with Chinese characteristics” seems to be rather catholic in its embrace. The “primary stage of socialism” and the development of “the commodity economy” appear to be compatible with almost all institutions of a market, i.e. capitalist, economy. Unlike in the Mao era, the main focus of the post-Mao Chinese leadership is clearly not socialism as such but the development of the “forces of production,” or more specifically the “four modernizations” adumbrated by Deng Xiaoping a decade ago. Perhaps that is as it should be, but in any case it is the standpoint adopted in this paper in relation to the question of the usefulness of the institution of the stockmarket in the present conditions of the Chinese economy. The question of system-compatibility of the stockmarket remains, however, an important one in a country like Yugoslavia where there has been a serious discussion of the extent to which the workings of the stockmarket would conflict with socialist values and institutions, particularly with labour managed firms.[24]

[24] For a recent survey of this discussion, see Uvalic 1988.

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